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PUBLIC SERVICE
COMMISSION

ATTORNEY FOR INTERVENOR
COLSTRIP ENERGY LIMITED PARTNERSHIP

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

* * * * *

IN THE MATTER OF Joint Application)	UTILITY DIVISION
In Compliance with Consent Order and)	
Required Notification Submitted Jointly by)	DOCKET NO. D2006.6.82
NorthWestern Corporation and Babcock)	
And Brown Infrastructure Limited)	

COLSTRIP ENERGY LIMITED PARTNERSHIP'S AND
YELLOWSTONE ENERGY LIMITED PARTNERSHIP'S
RESPONSE BRIEF

I. INTRODUCTION.

Petitioners Colstrip Energy Limited Partnership (hereinafter "CELP") and Yellowstone Energy Limited (hereinafter "YELP"), acting by and through undersigned counsel, hereby submit their response brief in the above-captioned docket. NorthWestern Energy (hereinafter "NWE") presents the Montana Public Service Commission (hereinafter "MPSC") with a host of very difficult issues arising from the analysis of the Babcock and Brown Infrastructure Limited (hereinafter "BBI") purchase of NWE. The specific issues discussed by intervenors are critical to the Montana economy and business community. However, the suggestion in Michael Hanson's testimony that the basis of the sale is the need to placate shareholder concerns for value

maximization of their NWE stock in the short term does not clearly fit into the MPSC's mandate to regulate NWE for the protection of consumers. Michael Hanson stated:

At present, many of NWE's owners are investors with short-term ownership interests, solely concerned with maximizing their gains as quickly as possible, to the detriment of necessary long-term investment. NWE and its customers have no stability in this situation.

(Michael Hanson Testimony, p. 3, ll. 11-14.)

Perhaps the overall problem with the BBI proposal emanates from the central flaw that shareholder greed in the post-bankruptcy environment is a good point of origin for selecting a new NWE owner. The State of Montana's public policy for utility regulation logically cannot be driven by the need for shareholders to receive the highest price, but rather Montana consumers should receive reliable service at a fair price.

Counsel for the Montana Consumer Counsel ("MCC") stated similar concerns in his opening statement when he stated:

Consumer Counsel's position: Consumer Counsel believes that this merger cannot be approved as presently proposed because approving the merger as currently proposed is likely to degrade the ability of NorthWestern to provide adequate service at just and reasonable rates.

(Transcript, p. 22, ll. 2-7.)

CELP/YELP have a keen interest in NWE's continuing solvency and system reliability which this brief addresses. While no intervenor may have filed testimony urging outright rejection, the numerous conditions suggested by intervenors including the MCC do indicate that outright approval of BBI's proposal is troublesome and inappropriate.

II. MPSC AUTHORITY TO APPROVE MERGER.

NWE's and BBI's combined brief suggests on page 1 that the record and legal precedent require MPSC approval. Curiously, on page 5 of NWE/BBI's combined brief, NWE/BBI

suggest: “Under no reading of prior Commission precedent on statutory authority can it be argued that the Commission can directly reject the transaction.” (NWE/BBI Opening Brief, p. 5.)

It is hard to believe that the MPSC has the authority only to approve but not reject the proposed transaction. Presumably, the MPSC has the right to enforce the bankruptcy court’s approval of the Stipulation and Settlement Agreement dated July 8, 2004, among NWE, the MPSC and the MCC (the “Stipulation”) discussed herein. The authority to approve the transaction logically presupposes that the MPSC has the authority to reject the transaction through conditions or outright denial after reviewing the record. Why else would a hearing and record be necessary to review the proposed NWE/BBI transaction to determine compliance with the Stipulation and the public interest of Montana?

The record developed in the prefiled testimony and cross-examination suggests many appropriate and necessary conditions proposed by intervenors which are consistent with the Stipulation among NWE, the MPSC and the MCC, dated July 8, 2004. Specifically, Section 4 of the Stipulation states NWE agrees to the following ratepayer protections (which BBI/NWE now wish to modify) as follows:

1. Structural and Financial Separation. BBI as the proposed new owner with control of NWE will be NWE’s sole source of capital while at the same time making unregulated utility investments throughout the world. The Stipulation, Section 4(b)(i) “ring fencing” protection evaporates if BBI’s credit collapses or non-utility BBI investments suffer the same fate suffered by the previous NWE. NWE will be without new resources and creditors will seek BBI’s equity interest in NWE in a bankruptcy reorganization if BBI suffers the similar economic reversals incurred by the first NWE. In order to honor the intent to protect ratepayers in the Stipulation,

NWE must be a stand alone entity with its separate credit rating, cash, and operations, and not part of an unregulated parent removed from both the Montana jurisdiction and for that matter, federal jurisdiction in Australia. Ring fencing with BBI offers no protection against BBI's collapse for causes outside of Montana operations leading into bankruptcy which drags NWE into its parent's reorganization. Presumably, a BBI reorganization would be in Australia, governed by Australian law, and the MCC and the MPSC would be striving to protect ratepayer interests by long-distance.

2. Financial Matters. Section 4(b)(iii)(2) specifically protected Montana citizens by requiring NWE "... debt will be used solely to fund operations of the Parent Company's Public Utility Business." The Stipulation clearly provided for no non-recourse, non-utility transmission financing to be undertaken as NWE debt. Further, the Stipulation clearly prohibits by its terms BBI from doing NWE loans in 2009 and 2011 to distribute funds to BBI unrelated to Utility Operations in Montana. If the Stipulation's Financial Measures are to protect ratepayers and citizens of Montana, BBI/NWE must not make loans for purposes of making cash distributions unrelated to Utility Operations and the acquisition of Public Utility Assets. A cash distribution to BBI is not a permissible purpose under the Stipulation to borrow funds.

3. Non-Recourse NWE Financing. BBI/NWE proposes funding transmission line construction with non-recourse financing. Clearly, the Stipulation, Section 4(b)(iii)(8), requires a separate subsidiary or affiliate to undertake this transaction rather than using the utility's credit rating to obtain the loan. Non-recourse debt from NWE is still a NWE obligation which must be paid from revenues or creditors will look to NWE's equity and any other non-Utility Assets including a failed transmission line. Without this prudent protection to ratepayers, a default of

non-recourse financing (against Utility Assets) will still cause a NWE bankruptcy, once again subjecting the Montana economy to the rigors of a bankruptcy by NWE.

4. Retained Earnings. Dr. Wilson's testimony and BBI's model clearly demonstrate a BBI proposal to reduce NWE's book equity to less than 40% notwithstanding Stipulation Section 4(b)(iv) limitation of not less than 40% of book equity. The reduction in book equity or retained earnings proposed by NWE through excessive cash distributions does not eliminate the value of questionable "good will." Rather, NWE seeks to creatively use excessive good will as an asset (as if it could be sold in the market place) to maximize borrowing for cash distributions upstream to BBI. Clearly, the definition of "total capitalization" in the Stipulation, Section 4(b)(iv) specifically does not include \$1.147 billion of "valueless" good will to determine NWE's consolidated book value (see Transcript, p. 147). The MPSC should eliminate "good will" from the calculation of book equity in determining whether NWE meets the 40% test of book equity in the Stipulation.

5. Ratepayer Premium Payments. As proposed by BBI/NWE, NWE will make dividend distributions in excess of earnings and borrow significant amounts in 2009 and 2011 (nearly \$200 million) to make cash distributions upstream to BBI in excess of earnings. These loans and reductions of retained earnings must be repaid by ratepayers to pay NWE debt and replenish retained earnings (see Section 4(b)(viii)). The loans to BBI unrelated to the purchase of Utility Assets violate not only the 40% retained earnings limitation in the Stipulation, Section 4(b)(vii), but also Section 4(b)(iv) of the Stipulation by requiring ratepayers to bear the burden of BBI's premium price above NWE's book value.

6. Liquidity. BBI proposes in one day each quarter to have a letter of credit available to demonstrate \$100,000,000 liquidity in NWE (see Transcript, p. 211, ll. 8-12). The

Stipulation clearly requires such credit to be continuous and at all times available without conditions such as proposed by BBI for availability only one day each quarter. Essentially, the BBI/NWE proposal eliminates financial NWE liquidity for 89 days each quarter (assuming 90 days per quarter), and leaves NWE stripped of all cash, and at the mercy of BBI to pay bills and make needed capital investments as discussed in paragraph 1 above. If BBI is in financial difficulty, the cash may not be available to NWE, and an Australian court may be determining the future of Montana ratepayers. The MPSC should not abdicate its regulatory responsibility in favor of BBI and should require NWE to have liquid cash resources at all times to fulfill NWE's obligations as a regulated utility.

7. NWE Credit Rating. As a subsidiary of BBI without cash, NWE will not receive its own credit rating, especially in light of the BBI proposal to provide a credit facility available for only one day each quarter, while otherwise stripping from NWE all available cash for upstream distributions to NWE's shareholder.

The foregoing inconsistencies with the Stipulation which was consented to by NWE on July 8, 2004, and approved by the United States Bankruptcy Court, provide sufficient authority to the MPSC to have the right under both state and federal law to impose restrictions, outright rejection or even sanctions against NWE for violating the Stipulation. The BBI/NWE proposal which violates the Stipulation, and causes NWE to incur enormous costs to seek regulatory approval, should not result in ratepayers incurring costs (i.e., NWE passing those costs through in rates) to see if the MPSC really meant to enforce the Stipulation.

III. BBI/NWE RATE OF RETURN ISSUES AT BOTH FERC AND IN MONTANA.

In BBI/NWE's Opening Brief, the statement is made on page 18 as follows:

NorthWestern will continue to invest in maintenance, growth and infrastructure projects in accordance with its operating and long term asset

plans. In the future, to the extent NorthWestern requires additional capital for (unregulated) expansion projects it would, as it does now, determine if such investment had the ability to earn a reasonable rate of return and then request approval from its board of directors, whether that board is a public board or an internal board.

(BBI/NWE Opening Brief, p. 18, emphasis added.)

Absent from the record is any testimony or BBI representation what a “reasonable rate of return” might be for BBI to advance NWE funds for unregulated capital investments. Clearly, NWE will never have any cash for capital investments if the MPSC accepts BBI’s proposal to strip all cash from NWE except for \$100,000,000 of liquidity one day per quarter.

The MPSC should carefully review NWE’s October 10, 2006 filing of expert testimony of Dr. Michael Vilbert recommending a return on equity after tax of 12% for NWE based on comparisons with other utilities. Specifically, Dr. Vilbert’s testimony states as follows:

Q: CAN YOU PROVIDE A SIMPLE EQUATION FOR THE CALCULATION OF THE COST OF EQUITY CONSISTENT WITH THE MARKET-DETERMINED ESTIMATE OF THE SAMPLE’S AVERAGE OVERALL COST OF CAPITAL?

A. Yes. Consider the following equation to calculate the ATWACC.

$$\text{ATWACC} = r_d \times (1 - T_c) \times D + r_e \times F$$

Where r_d = market cost of debt

r_e = market cost of equity

T_c = corporate income tax rate

D = percent debt in the capital structure, and

F = percent equity in the capital structure

The cost of equity consistent with the overall cost of capital estimate (ATWACC), the market cost of debt and equity, the marginal corporate income tax rate and the amount of debt and equity in the capital structure can be determined by solving equation (1) for r_e . I use this equation to determine the return on equity consistent with the market determined ATWACC for the sample and with NorthWestern’s regulatory capital structure consisting of 51 percent equity.

Prepared Direct Testimony and Supporting Exhibits of Michael J. Vilbert on Behalf of NorthWestern, p. 16, ll. 19-22, through p. 17, ll. 1-12 (footnotes omitted), filed with the

Federal Energy Regulatory Commission, Docket No. ER07-46-000, dated October 10, 2006.

In order to determine the pre-tax cost to ratepayers for NWE/BBI's return on capital, Dr. Vilbert's testimony would indicate a pre-tax ratepayer costs (assuming a 39.4% combined state and federal tax rate) for new equity from BBI as a "... reasonable rate of return..." based on comparable utilities of 12% x 1.394 or 17% cost to ratepayers pre-tax. If the MPSC is willing to accept a 17% pre-tax return on equity for BBI investments, then clearly BBI is suggesting for new equity investments in NWE capital improvements will be available. Failing such authorization by the MPSC for pre-tax return on equity, then NWE presumably will receive no new BBI equity investment and the MPSC will have no authority to require BBI to invest at lower levels of return. In short, the BBI/NWE "...reasonable rate of return..." as explained by Dr. Vilbert means that without a 17% pre-tax return on equity, the MPSC has abdicated any regulatory ability to mandate new investments to maintain, improve or otherwise enhance the NWE electrical and gas distributions systems.

IV. IDAHO/MONTANA TRANSMISSION LINE.

In order to find incremental revenues to support BBI's needs for cash distributions, BBI modeled an approximately \$1 billion new unpermitted transmission line into the Idaho Power service area to transmit for sale, power from unspecified generating resources. The speculative venture proposed by BBI produces abundant cash from equity investments at returns suggested by Dr. Vilbert as noted above and provides the basis for cash distributions to BBI above those available from current NWE operations. What is missing from BBI/NWE's speculative proposal is the ultimate risk for non-recourse financing by NWE against utility equity (assuming non-

recourse debt) and the origin of the electric generating resources which would provide the power for transmission to non-Montana markets.

Non-recourse financing, as proposed by BBI/NWE, will not pledge utility assets but necessarily will involve NWE as the debtor of \$600-\$800 million of bonds pledging to repay interest and principal from the results of operation of the transmission line. If repayment of non-recourse debt for transmission cannot be achieved from transmission operations, then the bondholders will have NWE's equity and the worthless transmission line as security. This unfortunate speculative investment will lead to the second NWE bankruptcy if the transmission line is unsuccessful in covering debt service. The MPSC should, as a condition, require BBI to directly and solely obligate BBI and not NWE for making speculative commitments to build an unpermitted transmission line.

Perhaps equally troublesome is the source of generating capacity to support a \$1 billion transmission line from Montana south to Idaho with the returns on equity BBI will demand. There are no major generating plants proposed or in the permitting phase which will need a new transmission line. Current proposed federal and state regulation of CO₂ emissions without any presently viable technology to implement the proposed regulations severely limits the possibility of new plants. Existing EPA and Montana regulations for removal of mercury emissions further limit new plant development given presently non-existent commercial technology. Montana presently is not an environmentally friendly state in which to build new generation, let alone enough generation to support a new transmission line.

The generation which is available in Montana is the existing PP&L generation of the old Montana Power system. If these resources are transferred south through Idaho for higher prices in California markets, Montana will lose the backbone of its cheap and economic generation

resources. Such a result would enrich PP&L and enrich BBI, but the bottom line is that a new transmission line offers Montana ratepayers the opportunity to pay California market power rates (or higher if new state of the art generation must be built to satisfy CO₂ and mercury regulation). A successful transmission line is an unconscionably bad deal for Montana's consumers and a great benefit to BBI's shareholders, which would open the California market to cheap Montana generation and average Montana rates up to California levels.

V. NWE AREA CONTROL RESPONSIBILITY.

As essentially a nongenerating electric utility, NWE is in nearly a unique status as a regulated utility trying to maintain a stable area control grid without any generating resources producing spinning reserves. NWE has in the past relied contractually on Idaho Power to provide the spinning reserves to stabilize the grid but this contractual relationship appears to be ending in the near future.

In order to maintain the reliability to NWE's consumers that the Stipulation contemplated, the MPSC may have no choice but to deny the NWE sale to a merger partner who cannot maintain area control stability and reliability by providing spinning reserves and other generation to stabilize the Montana grid. There cannot be a result where the electrical grid in the Montana area of control has no spinning reserves for system stability because BBI offers NWE shareholders the best price to maximize shareholder post bankruptcy profits.

Prior to any approval of a BBI combination with NWE, BBI/NWE must satisfy the MPSC and FERC that the NWE area of control responsibility can be satisfied with existing WSCC minimum spinning reserve requirements on a long term basis. Without such comfort from BBI/NWE, the MPSC should not approve the BBI/NWE combination if the Montana area of control and grid is going to operating in a reliable and economical basis.

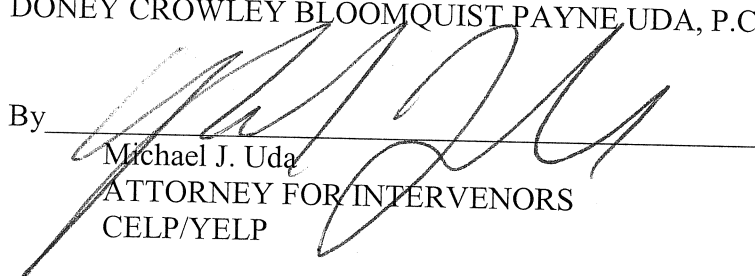
VI. CONCLUSION.

BBI/NWE have offered a proposal to merge which is driven principally by shareholder objectives to maximize shareholder return. The limitations of the Australian BBI stepping into NWE's responsibility to operate Montana's principal utility are challenging and, as proposed by BBI, in numerous areas unacceptable given the Stipulation and needs of the Montana economy for reliable utility service. The Commission must reject this merger as an unconscionably bad deal for Montana.

RESPECTFULLY SUBMITTED THIS 7TH DAY OF MAY 2006

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By



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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing was served, postage prepaid via first class U.S. mail on this 7th day of May, 2007 upon the following:

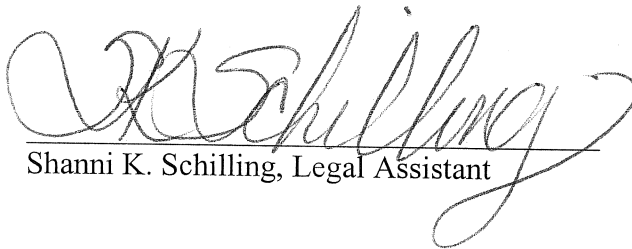
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